STATE AND MUNICIPAL STRENGTHENING PROGRAM

(ME-0208)

EXECUTIVE SUMMARY

Borrower: Banco Nacional de Obras y Servicios Publicos, SNC (BANOBRAS).

Guarantor: United Mexican States.

Executing agencies: Fast-disbursing component: Ministry of Finance and Public Credit (SHCP).

Line of credit component: BANOBRAS

Amount and source:

IDB: (Fast-disbursing) (OC)	US$ 400.0
IDB: (Line of credit)	US$ 400.0
Local:	US$ 400.0
Total:	US$1,200.0

Financial terms and conditions:

	Fast-disbursing	Line of credit
Amortization period:	15 years	25 years
Grace period:	5 years	4 years
Disbursement period:	2 years	5 years
Interest rate:	variable	variable
Inspection and supervision:	1%	1%
Credit fee:	0.75% on undisbursed balance	0.75% on undisbursed balance
Currency:	US dollars from the Single-Currency Facility	

Objectives: The general objective of this program is to support the process of decentralization in Mexico. The specific objectives are: (i) to increase the autonomy of local governments (states and municipalities, hereinafter "subnational governments" or "GSNs") in the allocation of resources; (ii) to improve the performance of credit markets at the subnational level; and (iii) to strengthen the capacity of GSNs to manage public funds.

Description: The decentralization process in Mexico is intimately related with the country's evolving political situation. Reform efforts inspired by various political currents are today combining to transfer greater responsibility to the GSNs. Although this process has been underway for the last ten years, a number of major new initiatives affecting the

GSNs have been proposed and in some cases undertaken during the period 1998-1999.

The program presented in this document has been designed with the express purpose of supporting these measures, through three components. **Component I** consists of a two-tranche sector operation to support national policy reforms in two areas: the system for transferring federal funds to GSNs, and the credit market that provides financing for GSN investments. With respect to the transfer system, the component will support introduction of a new budgeting mechanism, *Ramo 33* ["Section 33"], with features that will strengthen the autonomy of the GSNs. *Ramo 33* will transfer greater resources to the GSNs, in line with a pre-established disbursement schedule, and will allow them autonomy in deciding how to use these resources. Implementation of these reforms, which have already been introduced by the government, will serve as the basis for disbursing the **first tranche** of Component I. The **second tranche** is based on reforming the credit market for GSNs. First, a series of actions will be undertaken to correct shortcomings in the performance of BANOBRAS as the public source of credit for GSNs. The aim is to better enable BANOBRAS to meet the needs of its customers, with modernized procedures and structures and a more sustainable financial position. Second, changes will be made in the legal framework for the guarantee system, under which the Ministry of Finance and Public Credit (SHCP) now withholds GSN shares under the federal revenue-sharing program. These amendments will seek to establish a more transparent and reliable system by setting objective debt limits and transferring a portion of the credit risk to the banks. The conditionality matrix (see Annex I and the supporting information in Annexes II and IV) summarizes the reforms anticipated under this component.

As a supplement to these measures, **Component II**, an investment operation, is designed to encourage GSNs to adopt sound practices in their financial management, through a line of credit administered by BANOBRAS. The critical issues to be addressed under this component include local regulation of *Ramo 33*, investment planning and auditing, budgeting and accounting systems. Special attention will be paid to enhancing the transparency of the GSNs' financial performance. To the extent that they achieve the agreed goals of sound practice, they will have access to the line of credit to finance a portion of their investment plans. This component will also include resources to finance technical assistance for implementing the reforms called for under this program, or to undertake other institutional strengthening efforts, in accordance with the limits and eligibility criteria established in the Credit Regulations.

Component III will provide support for the reform process within BANOBRAS: it will provide financing initially for the Institutional Modernization Program (PDMI), and subsequently for further activities in pursuit of the organization's reform efforts. The PDMI will establish a strategy to ensure quality of service, efficiency and productivity, by rationalizing and optimizing BANOBRAS procedures with respect to costs, efficiency and risk.

Relationship of project in Bank's country and sector strategy:

The proposed program is consistent with the Bank's strategy for Mexico, as reflected in the country document (GN-2045-1) recently approved by the Board of Executive Directors. The program in fact falls under the first objective of that strategy, which seeks to reinforce the process of structural change through decentralization, with a view to fostering social development, reducing poverty, and promoting more harmonious regional development that will be both socially equitable and geographically balanced.

Environmental and social review:

The Environment and Social Impact Committee (CESI) approved the "Social and Environmental Report" on August 20, 1999, recommending that measures be taken to ensure that BANOBRAS has the institutional capacity to design an environmental management strategy and a program for monitoring and evaluation. The loan contract (Annex A) and the Program Operations Manual (MOP) for Component II will include recommendations for dealing with environmental issues.

Benefits:

Component I: The introduction of untied funding through *Ramo 33* marks the beginning of a new stage in the development of federalism in Mexico. Through *Ramo 33*, GSNs, and in particular the municipalities, will be able to decide for themselves how to allocate a growing volume of budgetary resources. Three aspects warrant special attention in this context: (i) the volume of funding involved is substantial (roughly US$20 billion in 1999); (ii) these transfers are performed through a set of clearly established fiscal principles aimed at achieving greater efficiency of expenditure; and (iii) these reforms represent a precedent for a politically and technically viable method of progressively transferring autonomy over budgetary expenditure to the GSNs.

Upon completion of the programmed reforms, BANOBRAS will have acquired valuable experience that will allow it to focus its efforts on working more closely with the GSNs and providing them with better services and products. It will also have changed the way in which decisions are taken within the organization, by decentralizing powers and responsibilities. Eliminating functions that are peripheral to its main mission will significantly improve its level of efficiency.

The government's plan for reforming the guarantee system, based on federal transfers, will put an end to the uncertainty caused by changes introduced in the Fiscal Coordination Act of 1996, since which time the Ministry of Finance and Public Credit (SHCP) has been operating under a transitional article of that Act. In addition, withdrawal of the federal government from operations under this scheme will reduce expectations that the Federation will intervene with its own funds to cover commitments and bail out the GSNs when they get into financial difficulty.

Component II. The line of credit will offer incentives to GSNs to strengthen aspects of their financial management, thereby complementing the decentralization measures undertaken by the federal government. In particular, the regulations for *Ramo 33* and the strengthening of the GSNs' investment management and their auditing, budgeting and accounting systems will allow them to meet the needs of their citizens in a more efficient and equitable manner. Strengthening the transparency of their operations will provide civil society, political forces and financial agents alike with better means for evaluating GSN performance.

Risks:

Component I. With respect to the mechanism for transferring additional resources to the GSNs, it is clear that there are great differences in the managerial capacity of GSNs to assume their new responsibilities, and this represents a high risk for the process of decentralization. Nevertheless, there are two factors that should help to mitigate this risk: (i) in the political sphere, the GSNs have recently become much more democratic; and (ii) Component II of this program is aimed at facilitating and implementing a process to strengthen GSN management so as to ensure greater transparency.

There is a risk that the BANOBRAS reform program will not be carried to completion, or that when it is completed a decision might be taken to halt or reverse the process of change. Nevertheless, once a program of this type is launched, it takes on a dynamic of its own, which will be difficult to derail arbitrarily. It should be noted that the SHCP, which is responsible for the development banking system, has expressed strong interest in the program as a means for achieving a thorough overhaul of the organization. Moreover, the program offers parallel but consistent incentives to all major players. If it fails to achieve the goals set out in the conditionality matrix, the SHCP will not have access to the second tranche of Component I, and BANOBRAS will not be able to access the line of credit.

With respect to the guarantee system, the government is proposing a system of incentives based on the functioning of the credit market. The effectiveness of these incentives will depend on whether the authorities amend the rules governing minimum levels of capitalization for financial intermediaries. The government has undertaken with the International Monetary Fund (IMF) to review the capital adequacy rules for the banks and to bring them more closely into line with international standards.

Component II. Although BANOBRAS has extensive experience in financing technical cooperation and institutional strengthening programs, it has no track record in executing policy-oriented investment programs. BANOBRAS faces an ongoing conflict, common to most development banks, between policy objectives and the need to keep placing funds in new transactions. Despite this, it is clear that the senior administration of BANOBRAS has identified this as an area where BANOBRAS can play an important role, and one that could not readily be performed by the commercial banking system.

Special contractual clauses:

Component I (fast-disbursing): Disbursements will be made in two tranches of US$200 million each, and will be subject to fulfillment of the conditions precedent for each tranche shown in the matrix in Annex 1 of this document.

Six months after initiating the execution plan for the Institutional Modernization Program (PDMI), BANOBRAS and the Bank will hold a follow-up meeting to agree on any necessary adjustments to that plan (paragraph 3.3).

Component II (line of credit): The first disbursement under this component will be subject to compliance with the following conditions: (i) presentation of the funds transfer agreement signed between BANOBRAS and the guarantor (3.1); and (ii) entry into force of the MOP for Component II and the model contract that will be used for the subloans (3.22).

Other special conditions for Component II: Independent consultants will be hired to conduct: (i) evaluations of the first five GSN diagnoses and action plans; and (ii) annual evaluations of the quality of diagnoses and action plans, progress achieved in their implementation, and the use of resources from the component in accordance with the loan contract, on the basis of a 10% sample of participants, with a minimum of two per year (3.14; 3.44).

Independent external auditors will be responsible for examining a sample of the supporting documentation for disbursement requests (3.39).

Component III (Institutional Strengthening of BANOBRAS). Presentation of the plan of execution for the Institutional Modernization Program (PDMI) will be a condition precedent to the first disbursement.

Poverty-targeting and social sector classification:

Although the proposed program will support the process of decentralization and strengthen the management capacity of the GSNs, which will obviously help the government to improve equity, reduce levels of poverty and enhance public welfare, there are no specific activities or mechanisms targeted directly at alleviating poverty.

Procurement of goods, works, and consulting services:

Direct contracting of COINFIN Ltd. As an exception to the procedures for selecting consultants through public bidding, it is recommended that the firm Financial Institutions Consultants (COINFIN) be hired directly. COINFIN has technical and institutional advantages and competitive fees for advising BANOBRAS on the PDMI, and this approach is consistent with chapter GS-403 of the Procurement Manual (3.36).

International competitive bidding (ICB) for goods and services. It is proposed that international competitive bidding be required for project procurements in amounts above US$1 million for goods and US$10 million for works. These limits are justified in light of experience with other projects financed by the Bank in Mexico, where foreign bidders tend to participate in procurement opportunities above those limits. Moreover, the fact that many companies from Bank member countries are associated with Mexican companies will ensure a high level of participation and representation. Bidding for amounts below these limits will proceed in accordance with national legislation, which requires public bidding and in some cases calls for restricted invitations and/or direct awards, and these are compatible with Bank procedures (3.34). Detailed information is available in the project files in support of the request for this exception concerning the number and amounts of ICB contracts.

International competitive bidding (ICB) for the contracting of consultants. It is proposed that the limit be raised from US$200,000 to US$500,000. In the case of Mexico, where many foreign consulting firms from other member countries of the Bank are already associated with Mexican companies, the existing limits are not only costly in terms of advertising and time, but often present serious obstacles to the contracting of consultants, and this has resulted in unnecessary delays in the performance of studies or specific activities, thereby needlessly holding up disbursements and delaying execution of projects financed by the Bank (3.35). Details on recent consulting contracts above the proposed limits is available in the project files.

Recognition of expenditures:

It is recommended that retroactive financing with loan resources be authorized up to US$15 million, and that expenditures be recognized against the local counterpart contribution, up to US$10 million, for outlays during the preparation and initiation of activities under Component II (3.41).